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Person to Contact:

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Refer Reply To:
CC:DOM:P&SI:4 - PLR-111237-98
Date: May 19, 1999

Re:

Legend:

Decendent	=
Year 1	=
Corporation	=
Z	=
Child 2	=
Trust 2	=
Grandchild	=
State	=

This is in response to your letter dated November 18,1998, and prior correspondence, in which rulings were requested concerning the gift, estate, and generation-skipping transfer tax consequences of the proposed transactions described below.

Facts:

The facts and representations submitted are as follows:

Decedent died in Year 1, predeceased by his spouse. Under paragraph E of Article I of Decedent's will, the residue of Decedent's estate was divided into three equal shares, each held in a separate trust for the benefit of one of Decedent's three children. Trust 2 for the benefit of Child 2 is the subject of this ruling.

At his death, Decedent owned shares of stock representing a significant interest in Corporation. Corporation has approximately 300 shareholders and is neither publicly traded nor closely held. Decedent's issue collectively own or control a significant fraction of the outstanding shares of Corporation. Child 2 does not currently serve as an employee or board member of Corporation.

Under a restrictive stock agreement, Corporation has the right of first refusal in any sale of Corporation stock. For this purpose, the board of directors updates the value of the stock every 6 months.

Decedent's stock in Corporation passed to the children's trusts. Each trust receives dividends of approximately $Z, annually, and distributes all trust income currently. The only assets in Trust 2 are shares of common voting stock in Corporation and a parcel of real estate.

The trusts for Decedent's children are administered under identical provisions. Under paragraph E.1. of Article I of Decedent's will, during Child 2's life, Child 2 is to receive the income from Trust 2 and any amount of principal the trustee, other than Child 2, thinks advisable for the support of Child 2 and Child 2's spouse, or the support, education, and welfare of Child 2's children and their spouses.

Paragraph E.2. of Article I provides:

> Each child who survives [Decedent] shall have the power to withdraw principal from his or her share from time to time, provided that the aggregate of such withdrawals in any calendar year shall not exceed the greater of (i) five thousand dollars ($5000) or (ii) five per cent (5%) of the value of the principal of the share at the time of the last withdrawal in the calendar year, and provided further that no voting shares of [Corporation] shall be so withdrawn or sold to permit such withdrawals without the consent of my trustees.

Paragraph E.3. of Article I provides:

> Each child who survives [Decedent] shall have the power, by signed writings delivered to the trustees during his or her life or by will specifically referring to this power, to appoint the principal of his or her share either outright to or in further trust for any one or more of a class composed of the child's spouse, the child's issue and their spouses, my other children, their spouses and issue, and charities.

Under paragraph D of Article II, Child 2 has the right, subject to the restrictive stock agreement, to purchase any part of the stock or securities in Corporation held in the trusts created under Decedent's will.

It is represented that, currently, Child 2 is the sole trustee of Trust 2. Child 2 proposes to exercise by deed the special power of appointment granted under paragraph E.3. of Article I. The deed will provide that Child 2's exercise of the power is irrevocable and that, upon Child 2's death, the remaining principal of Trust 2 will be held in trust and administered as follows: If Grandchild is then living, Grandchild will be paid the net income at least quarter-annually for life. At Grandchild's death, or if Grandchild is not living at Child 2's death, the remaining principal will be distributed among Grandchild's then living issue, per stirpes. Any trust created under this exercise of Child 2's special power must terminate and be distributed outright not later than 21 years after the death of the issue of Child 2 who were living at Decedent's death. Pursuant to paragraph E.3. of Article I of Decedent's will, the deed will recite that Child 2, as trustee of Trust 2, acknowledges receipt of the deed of exercise and authorizes the recording of the deed as appropriate under applicable State law. State.

Immediately after Child 2's exercise of the special power of appointment and the recording of the deed, Child 2 will resign as trustee of Trust 2 and appoint Grandchild as trustee. It is represented that Grandchild is an adult and that Child 2 does not financially support Grandchild nor does Grandchild financially support Child 2.

You have requested that we rule as follows:

1. Under § 2514(e) of the Internal Revenue Code and § 25.2514-3(c)(4) of the Gift Tax Regulations, Child 2's resignation as trustee of Trust 2 does not cause a transfer for federal gift tax purposes, because the resignation is deemed to be a lapse of a general power of appointment over less than 5 percent of the value of the assets of Trust 2.

2. Under Example 1 of § 20.2041-3(c)(2) of the Estate Tax Regulations, and Example 1 of § 25.2514-3(c)(b)(2), the appointment of a succeeding life estate in Trust 2 to Child 2's child, Grandchild, will give Grandchild a substantial interest in Trust 2 adverse to that of Child 2.

3. Under § 2514(c)(3)(B), after Child 2's proposed exercise of the special power of appointment and the appointment of Grandchild as successor trustee of Trust 2, Child 2's noncumulative power to withdraw the greater of $5,000 or 5 percent of the value of the

trust corpus annually (5 and 5 power) under paragraph E.2. of Article I will not constitute a general power of appointment over Corporation voting stock held by Trust 2 for purposes of § 2514.

4. Under § 2041(b)(1)(C)(ii), after Child 2's proposed exercise of the special power of appointment and the appointment of Grandchild as successor trustee of Trust 2, Child 2's 5 and 5 power will not constitute a general power of appointment over Corporation voting stock held by Trust 2 and will not result in the inclusion, under § 2041(a)(2), in Child 2's gross estate of any Corporation stock over which the power could be exercised.

5. As a trustee of Trust 2, Grandchild will not possess a general power of appointment pursuant to paragraph E.1. of Article I under either § 2041 or § 2514.

6. After Child 2's proposed exercise of the special power of appointment and the appointment of Grandchild as successor trustee of Trust 2, although 5 percent of the value of Trust 2 assets other than Corporation stock will be included in Child 2's gross estate under § 2041 for federal estate tax purposes, the value of Corporation stock held by Trust 2 will not be includible in Child 2's gross estate under § 2035, even if Child 2's death occurs immediately after the proposed transactions.

7. The proposed trustee resignation and successor trustee appointments will not constitute an addition to Trust 2 under § 26.2601-1 of the Generation-Skipping Transfer Tax Regulations or a modification of Trust 2 that will cause Trust 2 to lose exempt status for generation-skipping transfer tax (GSTT) purposes.

Law and Analysis:

Sections 2041 and 2514

Section 2041(a)(2) of the Internal Revenue Code provides that the value of the gross estate shall include the value of all property to the extent of any property with respect to which the decedent has at the time of death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition that is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§ 2035 to 2038, inclusive.

Section 2041(b) provides that the term "general power of appointment" means a power that is exercisable in favor of the individual possessing the power, his estate, his creditors, or the creditors of his estate.

Under § 2041(b)(1)(C), a power of appointment created after October 21, 1942 (a "post-1942 power"), which is exercisable by the decedent only in conjunction with another person shall not be deemed a general power of appointment if the power is not exercisable by the decedent except in conjunction with the creator of the power or in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent.

Under § 2041(b)(2), the lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power, during any calendar year, to the extent that the property which could have been appointed by exercise of such lapsed power exceeds in value the greater of (1) $5,000, or (2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed power could be satisfied.

Section 20.2041-1(c)(1) provides that a power of appointment is not a general power if by its terms it is either (a) exercisable only in favor of one or more designated persons or classes other than the decedent or his creditors, or the decedent's estate or the creditors of his estate, or (b) expressly not exercisable in favor of the decedent or his creditors, or the decedent's estate, or the creditors of his estate.

Under § 20.2041-3(c)(2), Example 1, the decedent and R are trustees of a trust under which the income is to be paid to the decedent for life and then to M for life; R is the remainderman. The trustees have the power to distribute corpus to the decedent. Since R's interest is substantially adverse to an exercise of the power in favor of the decedent, the decedent does not have a general power of appointment. If M and the decedent were trustees, M's interest would also be adverse to that of the decedent.

Section 20.2041-3(d)(3) provides that the failure to exercise a power of appointment created afer October 21, 1942, within a specified time, so that the power lapses, constitutes a release of the power. However, such a lapse during any calendar year is treated as a release only to the extent that the property which could have been appointed by exercise of such lapsed power exceeds in value the greater of (1) $5,000, or (2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed power could be satisfied.

Section 2501 of the Code provides for a gift tax on the transfer of property by gift. Section 2511 provides that the gift tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Under § 2514(b), the exercise or release of a general power of appointment created after October 21, 1942, is deemed the transfer of property by the individual possessing such power.

Under § 2514(c), "general power of appointment" is defined as a power which is exercisable in favor of the individual possessing the power ("the possessor"), his estate, his creditors, or creditors of his estate. However, under § 2514(c)(3)(B), a power of appointment (created after October 21, 1942) is not a general power of appointment if it is exercisable by the possessor only in conjunction with another person having a substantial adverse interest in the property subject to the power, which is adverse to exercise of the power in favor of the possessor.

Under § 25.2514-1(c)(1), a power of appointment is not a general power if by its terms it is either (a) exercisable only in favor of one or more designated persons or classes other than the decedent or his creditors, or the decedent's estate or the creditors of his estate, or (b) expressly not exercisable in favor of the decedent or his creditors, or the decedent's estate, or the creditors of his estate.

Under § 25.2514-3(b)(2), Example 1, the taxpayer and R are trustees of a trust under which the income is to be paid to the taxpayer for life and then to M for life; R is the remainderman. The trustees have the power to distribute corpus to the taxpayer. Since R's interest is substantially adverse to an exercise of the power in favor of the taxpayer, the taxpayer does not have a general power of appointment. If M and the taxpayer were trustees, M's interest would also be adverse to that of the taxpayer.

Section 2514(e) provides that the lapse of a power of appointment created after October 21, 1942, during the life of the power holder, is considered a release of such power, during any calendar year, to the extent that the property which could have been appointed by exercise of such lapsed power exceeds in value the greater of (1) $5,000, or (2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed power could be satisfied.

Under § 25.2514-3(c)(4), the failure to exercise a general power of appointment created after October 21, 1942, within a specified time so that the power lapses, constitutes a release of the power. The regulation further provides that if a trustee has in his capacity as trustee a power which is considered a general power of appointment, his resignation or removal as trustee will cause a lapse of his power. However, under § 2514(e), a lapse during any calendar year is considered as a release for gift tax purposes only to the extent that the property which could have been appointed exceeds the greater of (1) $5,000, or (2) 5 percent of the aggregate value, at the time of the lapse, of the assets out of

which, or the proceeds of which, the exercise of the lapsed power could be satisfied.

Under paragraph E.2. of Article I of Decedent's will, Child 2, as beneficiary, has the power to withdraw in each calendar year principal from Trust 2 with an aggregate value not exceeding the greater of $5,000 or 5 percent of the value of the principal of Trust 2 at the time of the last withdrawal. Under §§ 2041(b) and 2514(c), such a withdrawal power is a general power of appointment.

Paragraph E.2. of Article I further provides that "no voting shares of [Corporation] shall be so withdrawn or sold to permit such withdrawals without the consent of my trustees." Thus, to the extent that the assets of Trust 2 consist of voting shares of Corporation stock, Child 2 can only appoint property from Trust 2 to herself with the consent of the trustee.

It is represented that Child 2 is the sole trustee of Trust 2. Therefore, currently, Child 2's power to withdraw voting shares of Corporation stock from Trust 2 is exercisable only in conjunction with a trustee who has no substantial adverse interest to Child 2. Under §§ 2041(b)(1)(C)(ii) and 2514(c)(1)(B), while Child 2 (or any other person without interests substantially adverse to those of Child 2) is the trustee of Trust 2, Child 2's 5 and 5 power under paragraph E.2. of Article I over voting shares of Corporation stock remains a general power of appointment. Thus, as the beneficiary, Child 2 holds a general power of appointment over all of the Trust 2 assets other than voting stock in Corporation; as beneficiary and trustee, Child 2 holds a general power of appointment over the voting stock in Corporation held by Trust 2.

Child 2 proposes to exercise the special power of appointment granted under paragraph E.3. of Article I of Decedent's will. Under the proposed exercise, Grandchild will receive, on the date of exercise, the right to be paid a share of Trust 2 income for life, beginning upon the death of Child 2, if Grandchild is then living.

After exercising the special power of appointment, Child 2 will resign as trustee and appoint Grandchild as her successor trustee. Under § 25.2514-3(c)(4), Child 2's resignation will cause a lapse of Child 2's general power of appointment. However, under this regulation, the lapse will not be treated as a release of a general power, because the property subject to the general power Child 2 holds as trustee cannot exceed the greater of $5,000 or 5 percent of the aggregate value of Trust 2 assets at the time of the resignation. Accordingly, based on the facts submitted and representations made, we conclude that, under § 2514(e) and § 25.2514-3(c)(4), Child 2's resignation as trustee will not constitute a taxable transfer under § 2511 for federal gift tax purposes.

After Child 2's exercise of the special power, her resignation as trustee, and the appointment of Grandchild as successor trustee, Grandchild will have an interest in Trust 2 similar to the interests in Examples 1 of §§ 20.2041-3(c)(2) and 25.2514-3(b)(2). Grandchild will have an income interest succeeding that of Child 2 and will have the power to consent to Child 2's exercise of the 5 and 5 withdrawal power granted under paragraph E.2. of Article I. Accordingly, based on the facts submitted and representations made, we conclude that, for purposes of §§ 2041(b)(1)(C)(ii) and 2514(c)(3)(B), upon Child 2's exercise of Child 2's special power of appointment under paragraph E.3. of Article I, assuming the exercise is valid under state law, Grandchild will have a substantial interest in Trust 2 adverse to that of Child 2.

After Child 2 resigns as trustee and Grandchild is appointed as successor trustee, Child 2's 5 and 5 power to withdraw Corporation stock under paragraph E.2. of Article I will be exercisable only in conjunction with Grandchild, who will have a substantial adverse interest in the trust. Accordingly, based on the facts submitted and representations made, we conclude that, under § 2514(c)(3)(B), after Child 2's proposed exercise of the special power of appointment, assuming the exercise is valid under state law and that Grandchild or some other person with a substantial interest in Trust 2 adverse to that of Child 2 is acting as trustee, for purposes of § 2514, Child 2's 5 and 5 withdrawal power under paragraph E.2. of Article I will not constitute a general power of appointment over Corporation voting stock held by Trust 2. We further conclude that, under § 2041(b)(1)(C)(ii), after Child 2's proposed exercise of the special power of appointment, assuming the exercise is valid under state law and that Grandchild or some other person with a substantial interest in Trust 2 adverse to that of Child 2 is acting as trustee, Child 2's 5 and 5 withdrawal power under paragraph E.2. of Article I will not constitute a general power of appointment over Corporation voting stock held by Trust 2 and will not result in the inclusion, under § 2041(a)(2), in Child 2's gross estate of any Corporation stock over which the power could be exercised.

As discussed above, consent of the trustees is not required under paragraph E.2. of Article I for Child 2 to exercise the power to withdraw assets other than Corporation stock. Thus, after Grandchild is appointed as successor trustee, Child 2 will continue to have a general power of appointment under paragraph E.2. of Article I, for purposes of §§ 2041 and 2514, over Trust 2 assets other than Corporation stock. Accordingly, based on the facts submitted and representations made, we conclude that, at the death of Child 2, Trust 2 assets other than Corporation stock will be includible in Child 2's gross estate to the extent of Child 2's 5 and 5 withdrawal power under paragraph E.2. of Article I.

Under paragraph E.1. of Article I, a trustee "other than [Child 2]" may distribute to Child 2 any amount of principal the trustee deems advisable for the support of Child 2 and Child 2's spouse, or the support, education, and welfare of Child 2's children and their spouses. As trustee of Trust 2, Child 2 has no power of any kind under this provision to distribute principal to herself. Consequently, Child 2's resignation as trustee and appointment of Grandchild as successor trustee does not result in the exercise, lapse, or releases of a power of appointment by Child 2 under paragraph E.2. of Article I pursuant to § 2514.

Further, when Grandchild becomes trustee of Trust 2, Grandchild will be authorized, under paragraph E.1. of Article I, to make distributions of principal measured by Grandchild's own needs, but will only be permitted to make these distributions to Child 2. It is represented that Grandchild has no legal obligation to support Child 2, and Child 2 has no legal obligation to support Grandchild. Therefore, the provisions of paragraph E.1. of Article I do not create in Grandchild, as trustee, a general power of appointment, for purposes of §§ 2041 and 2514, over any of the assets of Trust 2. Accordingly, based on the facts submitted and representations made, we conclude that as a trustee of Trust 2, Grandchild will not possess a general power of appointment pursuant to paragraph E.1. of Article I under either § 2041 or § 2514.

Section 2035

Section 2035(a) provides for the inclusion in the gross estate of property transferred within three years of the decedent's death, if the property would have been included under §§ 2036, 2037, 2038 or 2042 if the decedent had retained the transferred property until death. Other transfers made within three years of death are not includible in the gross estate. Sections 2036, 2037, and 2038 provide for the inclusion in the gross estate of property of which the decedent has made a transfer and in which the decedent has either retained an interest in the property or a power over the property. Section 2042 provides for the inclusion in the gross estate of the proceeds of life insurance over which the decedent has retained any incidents of ownership.

Based on the facts submitted and representations made, we conclude that after Child 2's proposed exercise of the special power of appointment, her resignation as trustee, and the appointment of Grandchild as successor trustee of Trust 2, although 5 percent of the value of Trust 2 assets other than Corporation stock will be included in Child 2's gross estate under § 2041 for federal estate tax purposes, the value of Corporation stock held by Trust 2 will not be includible in Child 2's gross estate under § 2035, even if Child 2's death occurs immediately after the proposed transactions.

Section 2601

Section 2601 imposes a tax on each generation-skipping transfer (GST).

Under § 1433(a) of the Tax Reform Act of 1986, the generation-skipping transfer tax (GSTT) is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Tax Reform Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer from a trust if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date.

Section 26.2601-1(b)(1)(v)(A) provides that, except as provided under § 26.2601-1(b)(1)(v)(B), where any portion of a trust remains in the trust after the post-September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse.

Section 26.2601-1(b)(1)(v)(B) provides a special rule for certain powers of appointment. This section provides that the release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in § 2041(b)) will not be treated as an addition to a trust if (1) such power of appointment was created in an irrevocable trust that is not subject to Chapter 13 under § 26.2601-1(b)(1), and (2) in the case of an exercise, such power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years.

As concluded above, under § 25.2514-3(c)(4), Child 2's resignation as trustee will be treated as a lapse of a general power of appointment that does not constitute a taxable transfer for federal gift tax purposes. Further, the appointment of Grandchild as successor trustee will not confer any additional powers or beneficial interests upon Grandchild. Accordingly,based on the facts submitted and representations made, we conclude that the proposed trustee resignation and successor trustee appointments, as discussed above, will not constitute an addition to Trust 2 under § 26.2601-1 of the Generation-Skipping Transfer Tax Regulations or a modification of Trust 2 that changes the quality, value or timing of any beneficial interest provided for

under the trust. Therefore, the proposed trustee resignation and appointments will not cause Trust 2 to lose exempt status for GSTT purposes.

Except as we have specifically ruled herein, we express no opinion on the federal tax consequences of the transactions under the cited provisions of the Code or under any other provisions of the Code.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Assistant Chief Counsel
(Passthroughs and Special Industries)

By _____
Katherine A. Mellody
Senior Technician Reviewer
Branch 4

Enclosure:
Copy for section 6110 purposes